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Transition and Macro-Adjustment

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After Socialism and Dirigisme

Which Way?

Andrés Solimano

No universally valid blueprint exists for how to reform an economy, but certain patterns have emerged. This paper reviews alternative strategies for reform and their performance in mixed and post-socialist economies.

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This paper — a product of the Transition and Macro-Adjustment Division, Country Economics Department — was presented at the conference, Economic Reform: Recent Experiences in Market and Socialist Economies, held July 6-8, 1992, in El Escorial, Spain. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Emily Khine, room N11-061, extension 39361 (September 1992, 50 pages).

Solimano identifies fundamental economic changes in the last 20 years that have influenced the emergence of a new paradigm on economic reform. The new orthodoxy on economic reform emphasizes smaller government, trade liberalization, business deregulation and privatization, macroeconomic austerity, and the role of free markets for resource allocation and growth.

After describing diverse country experiences in economic reform, Solimano summarizes his findings on key aspects of the design of economic reform programs. Among many findings:

- Shock treatment (as opposed to the gradual approach) requires a strong government with broad social support, as the costs of the policies are paid upfront and the benefits may take time to accrue. If the program involves protracted social hardship, political support will begin to evaporate and pressure will build for a reversal of reform.
- Important choices must be made about the sequence of macroeconomic adjustment and consolidation and structural reform. Implementing tax reform and converting quotas to tariffs improve the fiscal budget, so they contribute to macroeconomic stabilization. But premature financial liberalization, before the budget is balanced and real interest rates are at a reasonable level, may lead to financial crisis, as happened in Chile in 1982-83. Massive privatization of large-scale firms can have both stabilizing and destabilizing macroeconomic effects, for example. If it means getting rid of loss-making public enterprises, it could save scarce government resources. But if the resulting output and unemployment costs are socially unsustainable, pressure may mount for the government to come to the enterprises' rescue.
- The shift from an economy with controlled prices to one in which most prices are market-determined generally involves a big hike in price levels. Chile and Mexico illustrate the stubbornness of the inflation that may follow.
- China, Korea, and Chile represent countries that carried out economic reform under authoritarian governments that postponed political reform to gain political legitimacy from the fruits of consolidated economic reform. In countries where economic and political reform are pursued simultaneously (as in Eastern Europe and Russia), fragile democracies with a fragmented party system and weak social institutions and governments do not provide the most favorable political environment for implementing and consolidating complex and painful economic reforms. Under these conditions, governments are bound to face the dilemma of either postponing economic reform to avert a political crisis or to backslide in democratization to apply painful economic policies — both unsavory choices.

DIVERSITY IN ECONOMIC REFORM: A LOOK AT THE EXPERIENCE IN MARKET AND SOCIALIST ECONOMIES

By

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1. Introduction

Economic Reform is becoming a household word. It is used to describe the current attempts of transforming the structure and institutions of whole economic systems, in a wide variety of countries and contexts. Economic reform programs have been, or are currently being undertaken, in Latin America by countries like Chile, Mexico, Bolivia and very recently in Argentina. Post-socialist Eastern Europe and the former Soviet Union are also embarking in radical programs of economic reform that combine macroeconomic stabilization with liberalization policies. In the context of industrialized countries, the drive to free market economic reform gained impetus in the 1980s with the Thatcherist experiment in England and Reaganomics in the United States.

Clearly some common currents in policy formulation are permeating many countries, that not so long ago followed very dissimilar economic strategies; the most obvious case being the economies of the former socialist block. The new orthodoxy on economic reform places strong emphasis on the role of free markets for resource allocation and growth, smaller government, trade liberalization, business deregulation and privatization. In addition, macroeconomic austerity is seen as a prerequisite for implementation of these more structural reforms.

Evidently the new paradigm represents a sharp departure from previous development strategies in non-socialist developing countries based on state dirigism, controlled trade regimes and regulated markets for goods and factors. The departure is even more striking in the former socialist block where the institutions of capitalism are absent, key markets work poorly and/or simply do not exist and the state is the main owner of physical productive wealth in the country.

This paper has several purposes. First, it identifies some fundamental changes in the world economy in the last two decades or so that have influenced the emergence of a new paradigm on economic reform (section 2). Then, it discusses several issues of the design of programs of market-oriented reform combining macroeconomic restraint with liberalization. In particular the discussion focuses on the issue of: (i) intensity of the programs (shock treatment vs. gradualism); (ii) the potential conflicts between macroeconomic consolidation and rapid liberalization; (iii) performance indicators related to the speed of disinflation, the recessionary-stagnationist impact of the programs and their distributive effect (section 3).

Then the paper turns to several experiences with economic reform in **developing** market economies and in former socialist countries. The Latin American experience of the last two decades with countries combining macro stabilization and liberalization is reviewed. The analysis focuses on the cases of Chile, Mexico and Bolivia (section 4). Then the recent experience of implementing programs of adjustment and reform in different economies of Eastern Europe is assessed (section 5). Then the analysis turns to two "Asian Models" of reform: Korea and China. Those experiences differ from the Latin American and East European ones in terms of intensity of the programs and the relative priority attached to liberalization versus macroeconomic consolidation (sections 6 and 7). The discussion considers initial conditions before reform, the main elements in the programs of adjustment and liberalization, performance criteria regarding speed of macroeconomic stabilization, output response and transition to growth and distributive impact of the reforms. Some observations on the political economy under which the different programs are implemented will be provided. The paper concludes with a summing-up.

2. The emergence of a new paradigm on economic reform: origins

The 1990s is producing a remarkable sight. Both capitalist as well as formerly socialist economies alike are now embracing economic policies conducive to reshape their economic landscapes along free market lines. State-led development is clearly out of fashion, largely because of the Latin American crises of the 1980s and in spite (perhaps) of the East Asian record. Furthermore, Stalinist socialism is definitely dead.

Explaining the emergence and widespread acceptance of a new paradigm on economic policy is a hard task that involves grasping a complex interaction between events and ideas.

Major shocks to the world economy in the 1970s affected economic performance and led to a reassessment of priorities and the content of economic policies. The first oil shock in 1973 gave rise to the simultaneous worsening of macroeconomic conditions in industrialized countries as inflation accelerated along with a simultaneous rise in unemployment, a slow-down in output growth and a trend of slower productivity growth, (particularly in the US and Great Britain). In the realm of ideas on economic policy, the traditional post-World War II consensus combining demand management at macroeconomic level with a welfare state came under challenge. Reflecting these trends, England under Prime Minister Margaret Thatcher applied stiff anti-inflationary measures along with policies aiming to reduce the role of the state in the economy through the privatization of public enterprises, tax cuts and economic deregulation. A similar shift in emphasis and policy priorities took place in the US after the election of President Reagan in 1980. The new policies in the US centered around cutting taxes, reducing business deregulation and financial liberalization, in the context of increased fiscal deficits. Both in the US and Britain, excessive government involvement in economic activity and its outlets of taxes and regulation, (in England also the outgrowth of public enterprises) were identified as main causes behind sluggish capital formation, reduced entrepreneurial effort and meager productivity growth.

These changes in two main industrialized countries in the 1980s certainly shaped, albeit gradually, a new climate in economic policy thinking and formulation that eventually reached the developing world and the socialist block[1].

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[1] It is interesting that the reform policies in China, freeing agriculture and giving a new impetus to private sector activity, started in the late 1970s before the experiments in the US and the UK. Probably, a dominant influence in the Chinese process came from the remarkable dynamism of the neighboring NICs (Korea, Taiwan, Hong Kong, Singapore), see Sections 6

In the developing country context, particularly in Latin America, the strategy of import substitution industrialization (ISI) pursued since the thirties was already the subject of ample criticism because of its lack of dynamism, anti-export bias and its failure to correct endemic concentration in income distribution. The role of the state as a supporter of the ISI strategy and the deteriorating record in terms of fiscal imbalances and inflation led to a questioning of its role in the economy. The experience with radical market-oriented reform in Latin America can be traced to the early to mid-seventies, in the Southern Cone. Following the collapse of populist-socialist experiments, newly installed military regimes implemented sharp programs of macroeconomic restraint and liberalization in Chile, Argentina and Uruguay.[2]

Beyond the Southern Cone, the single, most important, shock that catalyzed the drive towards economic reform in Latin America was the debt crises of the eighties. The debt shock triggered a protracted period of stagnation, high inflation, fragile balance of payments positions and increased economic instability in the region. Increasingly, the economic dislocation of the eighties led to the perception that overcoming the economic crisis needed the restoration of macroeconomic equilibrium, a comprehensive change in the structure of the economy, fiscal reform, privatization, open the domestic economy to foreign competition. In the eighties, comprehensive programs along these lines were implemented in Mexico and Bolivia (Chile, as mentioned above, started its reforms in the mid-seventies); followed by Argentina in the early nineties.

In East Asia, the impressive performance of the NICs (Korea, Taiwan, Singapore, Hong Kong) in terms of high growth, rapid technical progress, enhanced international competitiveness, aggressive export penetration provided a case for outward orientation and stable macro policies as an engine for growth and development. Certainly, the experience of the NICs backed the new

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and 7.

[2] See Ramos (1986), Solimano (1990), Cardoso and Helwege (1992), Dornbusch and Edwards (1991) for analysis of that period.

drive for economic reform in the developing world, though these experiences, as we shall see later, represent a more eclectic model of reform regarding the role of the state and the relative importance given to liberalization vis-a-vis macro consolidation in the process of economic transformation.

The **coup de grace**, perhaps, in favor of market based reform was the collapse of the socialist experiment in Eastern Europe in the late 1980s, followed by the economic and political disintegration of the Soviet Union in late 1991. The sudden collapse of the socialist regimes gave rise to more radical programs, particularly in their liberalization component, in Eastern Europe compared to the Latin American counterparts of the seventies and eighties.

3. Program on design and performance

The standard package of market-based economic reform in an economy starting from pervasive imbalances includes measures of both macroeconomic stabilization and liberalization. Macro restraint involves tight demand policies (oriented to cut domestic absorption) coupled with real depreciation of the exchange rate (to gain external competitiveness).

Liberalization policies include reform of the trade regime, deregulation of controlled interest rates and other quantitative allocative mechanisms for credit, elimination of regulation preventing domestic and foreign investment in certain activities, privatization of public enterprises, changes in the tax system. Those policies are oriented to give markets a prominent role in the resource allocation and growth process and reshape existing institutions in order to make them more supportive to a market-based system.

The effects of changes in specific policy instruments on economic activity, inflation and real wages and other indicators of economic performance have been subject of debate for a long time. The controversy whether currency devaluations are contractionary or expansionary in the short term is one example, the rigidity of inflation in the face of cuts in money growth in chronic inflation countries, the stagnationist effects of cuts in real wages are other.[3] Recently, new evidence is being produced on the slow transition to medium-term growth in the aftermath of adjustment; in particular the existence of a long investment lag and reduced capacity utilization in the aftermath of adjustment.[4]

Radical and Moderate Packages: Two Views

Two views can be distinguished here regarding the intensity and priority given to macro adjustment and consolidation vis-a-vis liberalization in a reform program. One view emphasizes the fact that protracted austerity involves a contraction in both current and probably future output, through the adverse impact of sharp demand contraction on capital formation.[5] This view calls for gradualism, or at least moderation in the amount of demand contraction and currency depreciation, in an adjustment program, in order to avoid large cuts in real wages and a protracted slump in economic activity and growth. In addition, this view highlights the potentially destabilizing effects of rapid liberalization on macroeconomic stability. For example a cut in tariffs may involve a reduction in fiscal revenues hampering an already flimsy fiscal budget; moreover, overly costly programs from a social point of view may also give rise to future reversals because of the erosion of socio-political support to reforms that are associated with a protracted squeeze of living standards. Furthermore, an important distinction is made between shock treatment for stabilization purposes and gradualism in structural reforms that involve the restructuring of enterprises, banks, tax systems and building of new institutions.[6]

The other view, (the radicals) down plays the adverse effects of macro restraint on capital formation and growth and emphasizes the positive effects

[3] See Kiguel and Liviatan (1992), Solimano (1990), Taylor (1991a and 1991b).

[4] See Dornbusch (1991); Solimano (1992).

[5] See Serven and Solimano (1992a and 1992b).

[6] See Bruno (1992).

of liberalization on the productivity of investment and the alleged efficiency of growth in a liberalized policy regime. Moreover, this view favors shock therapy and rapid liberalization as a way to alter, **in a dramatic fashion**, the expectations of the private sector and, thus boosting capital accumulation and growth. This view rests upon the notion that a change in policy regimes, as distinguished from specific changes in policy instruments, is the fundamental force driving private sector response to the new set of policies put in place by a program of economic reform.[7]

In the context of post-socialist transformation an important area of controversy between "gradualists" and "big-bangers" is over the pace of privatization. The gradualist approach assumes that privatization is a problem of social transformation, therefore an inherently slow, evolutionary process.[8] The gradualist approach emphasizes privatization of small-medium size enterprise to create a critical mass of "genuine Schumpeterian entrepreneurs" with strong incentives for innovation and creation of new business. The privatization of large scale public enterprises would be a slow process whose progress will depend upon the advance made in the creation of other market institutions like a commercial banking system, regulatory agencies, etc.

The radical approach to privatization of large scale public enterprises of post-socialist countries[9] emphasizes the need for the state to quickly get rid of the large number of big state-owned enterprises. Since these enterprises are, often, loss making units, they put a burden on public finances that will be ultimately destabilizing; in addition rapid privatization will reduce the capacity of patronage by the state.

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[7] An influential paper along these lines, in the context of stabilization, programs is Sargent (1982).

[8] See Kornai (1990a) and (1990b).

[9] See Lipton and Sachs (1990b).

Performance Criteria

To assess performance of economic reform, we will focus on three criteria: (a) stabilization, in particular the speed of disinflation; (b) the response of investment and growth to adjustment policies; (c) the distributive impact of the reforms. Of course, other criteria could be added to get a more detailed evaluation of the programs.

Macroeconomic stabilization -- An important component of the programs of economic reform is macroeconomic stabilization. The accumulated experience on stabilization shows that reducing intermediate-high inflation, on a more or less permanent basis, is not an easy task, particularly in economies with a long history of inflation. Inertia, indexation and credibility problems are pervasive in these economies, making the task of stabilization more complicated. For example, the stabilization of high inflation in countries like Mexico, Chile, Israel shows that it may easily take half a decade or more for high inflation to converge to annual rates of the order of 20-25 percent. In socialist economies that start with repressed inflation, the process of eliminating price controls is proving to be a complicated one too. The magnitude of the initial inflationary outburst after price reform is large and the existence of persistence in inflation after the initial price shock is not trivial (see section 4).

Investment and Growth Response -- Macroeconomic restraint often leads to drastic cuts in public and private investment rates, at least during the initial phases of the adjustment process. When the contraction in investment rates becomes a protracted process, as it has been the case in most Latin American economies during the 1980s, this endangers the rate of expansion of productive capacities in the medium-term. In addition, it has been detected that the resumption of private investment after the initial contraction in adjusting economies may take several years.[10] Moreover, the recovery of public investment may take even longer, affecting, in a negative way, the process of creation of complementary infrastructure needed to support private

[10] See Solimano (1992).

investment, export and output growth. There are several reasons for the pattern of initial investment contraction followed by a delay in the response of private investment during an adjustment program: initial demand contraction and the creation of excess capacity, an increased value of waiting in a context of unconsolidated economic reform, the lack of supportive systems (public physical infrastructure, credit, legal system, etc.). Again, these problems are bound to be particularly critical for reforming socialist systems.

Distributive Impact -- Macroeconomic adjustment often brings about a cut in real wages both in the private and public sectors in order to support real currency depreciation and reduce current fiscal expenditures. In addition the slashing of government subsidies to credit and basic consumption goods also produces changes in real incomes of various groups (not necessarily a regressive move). Liberalization and privatization policies also have (largely unexplored) effects on the distribution of wealth.

The evidence gathered in two recent studies on the subject[11] conducted under auspices of WIDER and the OECD show that macro restraint and external shocks that entail massive cut in real wages and/or increases in unemployment hurt more the poor. Moreover, major regressive redistributions of wealth have taken place during financial crises following experiments of unregulated financial liberalization.[12] On the other hand, the efforts at targeting social spending in health and education during the course of adjustment has helped to reduce the social impact of these policies on the very poor, in spite of a trend of declining real social spending per capita detected in Latin America.[13]

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[11] The results of the WIDER project is reported in Taylor (1991) and the conclusions of the OECD project are presented by Bourgignon, de Melo and Morrison (1991).

[12] For example, massive subsidies to commercial banks and major debtors placed an enormous burden on public finances and forced to cut social and infrastructure spending in Chile after 1982.

[13] See Lusting (1992) for Mexico and Meller (1992) for Chile.

4. Radical Economic Reform In Latin America: Chile, Mexico and Bolivia

Comprehensive market-oriented programs of economic reform in Latin America started to be implemented since the mid-1970s in Chile, and in the mid-1980s in Mexico and Bolivia; see table 1 and figures 1 and 2. (Currently, Argentina is following similar policies though it is still a new and non-consolidated experience.)

Chile The military regime that toppled Allende in 1973, initiated a very ambitious program of free-market economic reform, at least given the economic climate prevalent at the time in Latin America. The program, implemented under tight authoritarian conditions, involved comprehensive macroeconomic stabilization and liberalization. At the time the reforms started to be applied, the Chilean economy exhibited large macroeconomic imbalances in the form of high inflation rates and a large fiscal deficit.[14] Inflation was slow to decline in spite of tough austerity -- the fiscal deficit was reduced from 25 percent of GDP in 1973 to near 3 percent in 1975. Already in October 1973 most of the system of controlled prices were lifted, and the exchange rate sharply devalued. Subsidies on credit and consumption goods were eliminated and all controls on interest rates lifted. In addition a gradual program -- over a four-year period -- of tariff reduction was enacted in order to bring down tariffs rates from three digit levels to an uniform import duty of 10 percent (by mid 1979). Public sector reform included large cuts in public sector employment, privatization of public enterprises, many of them nationalized under Allende, and the imposition of a value added tax to improve tax collection. In the second half of the seventies the Chilean economy experienced rapid growth in a context of declining inflation and consolidating fiscal adjustment. Nevertheless, during most of that period unemployment remained very high. Financial deregulation and currency overvaluation led to an overexpansion of financial intermediation, and the accumulation of a large stock of internal and external

[14] See Corbo (1985), Meller (1991), and Corbo and Solimano (1991) for a discussion of the reforms adopted in the Chilean economy in the last two decades.

debt. In 1982-83 the Chilean economy suffered a deep recession and a severe financial crisis as a consequence of adverse external shocks and previous policy mistakes. The post 1984 recovery was strong, with GDP growing at more than 6 percent per year (1984-89) in a context of relative macroeconomic stability, lower real interest rates and favorable copper prices (since 1987). In addition, a depreciated real exchange rate -- coupled with depressed real wages and a considerable pool of unemployed labor -- favored the rapid expansion of non-traditional exports, therefore helping to consolidate the improvement in external accounts, (see table 1 and charts 1-2).

The political economy of reform in Chile is an important element to be considered. The intensity of the reforms as well as its large social costs were possible, to a considerable extent, because they were applied under the particular conditions of a military regime that governed for many years without open political opposition as political parties were banned, main labor organizations declared illegal and with no parliament in operation. The situation started to be relaxed, towards the late 1980s following a preannounced transition to democracy that included a plebiscite in 1988 and a national election of president and parliament in late 1989. The democratic administration that took office in early 1990 maintained most of the economic policies implemented under the military regime. The bulk of the market-oriented system was preserved, though introducing changes in the labor legislation to rebalance the bargaining power of labor vis a vis capital, taxes were increased modestly and a program of social spending to alleviate poverty and improve income distribution patterns was initiated.

Mexico The Mexican economy for decades followed a strategy of import substitution, growing state involvement in the economy and corporatist politics. Mexico in the second half of the seventies, following the discovery of oil, engaged in a cycle of fiscal expansion, currency appreciation and large foreign debt accumulation that came to a sudden halt in 1982. In that year the country embarked in a drastic program of macroeconomic adjustment comprising demand restraint, real depreciation of the exchange rate and large

Table 1

Economic Indicators
Reforming Economies in Latin America: Chile, Mexico, Bolivia
(annual averages, percent)

			Growth Rate of GDP	Growth Rate of Exports	Growth Rate of Real Wages	Inflation Rate (CPI)	Investment (ratio of GDP)	Terms of Trade (1980=100)
Chile	Pre-reform Period	1960-70	4.3	3.6	6.0	25.7	20.6	165.1
		1971-73	0.7	-3.8	-8.7	296.0	14.7	175.3
	Reform Period	1974-81	3.9	14.4	10.0	163.9	17.2	121.5
		1982-85	-1.5	4.8	-4.4	19.0	10.5	82.4
		1986-91	6.0	11.9 a	2.9	19.2	16.7 a	86.8
		1974-91	3.4	11.4	3.7	84.1	15.6	101.3
Mexico	Pre-reform Period	1970-81	6.8	7.7	0.9	16.8	22.1	105.9
	Reform Period	1982-85	0.4	9.2	-7.0	71.0	16.8	99.4
		1986-91	1.7	5.1 a	1.6	67.0	16.8 a	69.5
		1982-91	1.2	6.9 a	-2.6	69.7	16.8 a	81.5
Bolivia	Pre-reform Period	1970-81	3.5	-0.9	1.0	19.6	14.4	76.2
		1982-85	-2.5	2.2	-3.3	3358.3	7.2	87.9
	Reform Period	1986-87	0.0	1.3	-7.3	145.5	5.1	56.0
		1988-91	2.9	16.8 a	9.5 c	15.7	6.1 a	55.0
		1986-91	1.9	10.6 a	--	59.3	6.4 a	55.3

Note: (a) Exports and Real Investment figures are available only up to 1990.
(b) Stabilization cum structural adjustment program was launched in August 1985.
(c) Figures refer to 1988-1990 period and are not directly comparable to previous years.

Source: World Bank, ECLAC (1990,1991).

Figure 1a
Monthly Inflation Rates in Chile

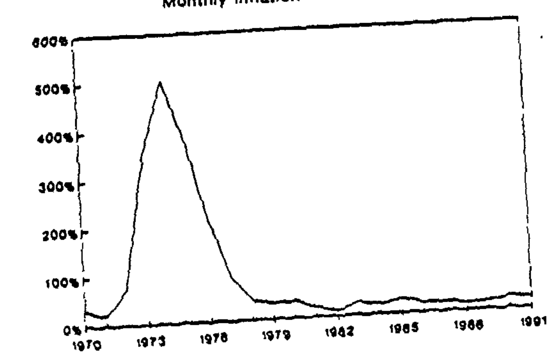


Figure 2a
Real GDP in Chile
(1985=100)

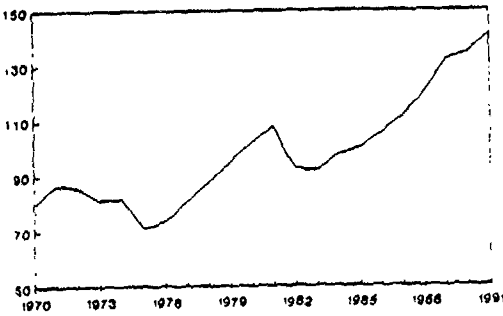


Figure 1b
Monthly Inflation Rates in Mexico

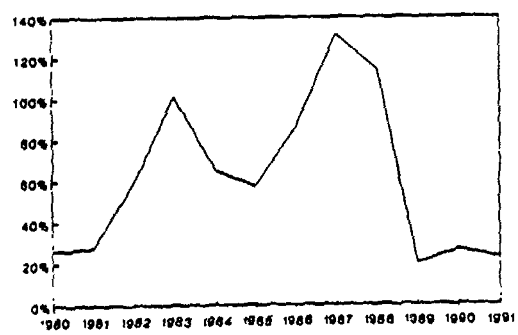


Figure 2 b
Real GDP in Mexico
(1985=100)

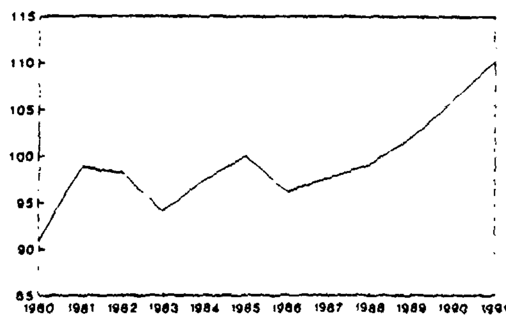


Figure 1c
Monthly Inflation Rates in Bolivia

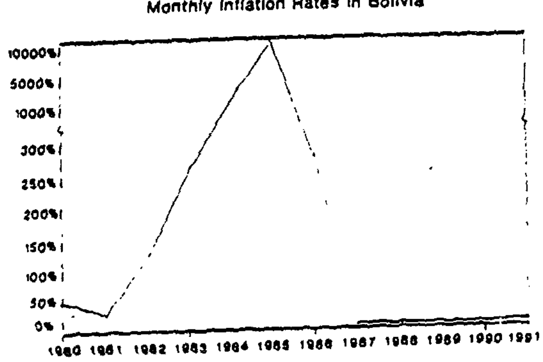
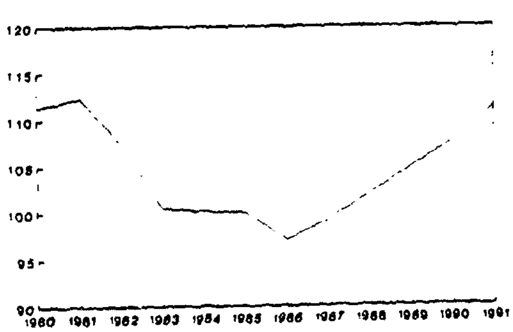


Figure 2c
Real GDP in Bolivia
(1985=100)



cuts in real wages. Those policies were further deepened since 1985 with trade reform, deregulation and market liberalization. Quotas were reduced from covering 100 percent of (non-oil) tradeable goods production to less than 17 percent at present, with a similar trend in tariffs.[15] In addition, the tax system was reformed, regulations on domestic and foreign investments were phased out, and the financial system was reformed. Moreover, a severe program of disinflation was launched in late 1987 that combined additional fiscal adjustment with incomes policies to abate a stubbornly high rate of inflation.[16]

After a long period of sluggish growth and slow disinflation, the Mexican economy started to show signs of recovery in 1988. Disinflation and the gradual recovery were boosted by a debt reduction deal in the context of the Brady initiative in 1989, the hastening of the privatization and deregulatory process and the initiative for a free trade agreement with the United States. During 1990-91, GDP grew at an average rate of 4 percent per year.

The political economy of the reforms in Mexico is interesting. They have been impulsed from within the ruling political system by a generation of young, highly qualified, economists within the PRI (Partido Revolucionario Institutional) a party that not so long ago backed for many decades a radically different development model based on state dirigism and import substitution.

<u>Bolivia</u> This is a case of free market reform in a small, poor economy (its level of income per-capita is below 600 hundred dollars),[17] strongly dependent on the export of a few mineral commodities -- natural gas and tin -- and with a small base of human capital and physical infrastructure.

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[15] See Van Wijnbergen (1991).

[16] An analysis of the stabilization program of late 1987 appears in Ortiz (1991).

[17] World Development Report, 1991.

Bolivia suffered mounting economic instability and negative GDP growth in the first half of the 1980s. This process culminated in the hyperinflation of the first eight months of 1985. In August of 1985 a drastic and successful anti-inflationary program was launched; as a result of it inflation declined from more than 25,000 per cent in 1985 to an average annual rate of 16.5 in the period 1987-1990. In addition, the anti-inflationary program was followed by a series of policies of structural adjustment including trade liberalization (tariffs rates were rapidly reduced after 1985 to a range between 5 to 10 percent). In addition, most of the system of price controls, state subsidies and guaranteed prices were eliminated. Public sector prices were adjusted to reflect opportunity costs, interest rates ceilings were removed and domestic and foreign commercial banks were allowed to receive deposits denominated in dollars.

The Bolivian program of economic reform started in 1985 provides an example of rapid elimination of a hyperinflation. In less than two years, as mentioned before, inflation was brought down (and maintained) at a level around 16 percent per year starting from four digit range. On the real side, the program of disinflation and liberalization was followed by a protracted period of depressed private investment and slow, albeit positive, GDP growth.

In spite of the success on the stabilization front the Bolivian program still shows signs of incomplete adjustment. The fiscal deficit averaged 5.4 percent of GDP in the period 1986-90, pushing real interest rates up and crowding-out private investment.[18] In addition, the financial system is highly dollarized as near 80 percent of the liabilities of the banking system are denominated in foreign currency, reflecting lack of confidence in domestic assets.

The Bolivian economic reform program was launched by a civilian government led by President Paz Estenssoro elected in 1985, after two decades of alternation of civilian and military government implementing a wide range

[18] Incidentally real interest rates in Bolivian pesos and also in dollars have remained well above international rates. See Calvo and Guidotti (1991).

of economic policies ranging from populism to orthodox austerity programs. The post-1985 reforms were implemented in democracy, though in a country with a large indigenous and peasant population with little incidence in formal politics.

A Look at Performance in the Three Countries

A full evaluation of the reform policies in the three countries, considering counterfactuals of alternative policies is beyond the scope of this paper. Nevertheless let us look at our performance criteria in the three countries.

Stabilization Performance. The experience with stabilization in Chile and Mexico and to a less extent Bolivia shows that reducing and stabilizing inflation is a costly and often lengthy process. In Mexico and Chile, it took between 6 to 7 years from the beginning of the program of stabilization, to reduce three-digits inflation to levels around 20-25 percent per annum (see table 2). In Chile the rate of inflation was over 600 percent in 1974 converging to levels below 20-25 percent per year just after 1981 in spite of stiff stabilization measures. In Mexico the rate of inflation was near 100 percent in 1982 reaching the critical range of 20-25 percent per year just in 1989. In contrast, the speed of stabilization in Bolivia was faster than in Chile and Mexico. The Bolivian case fits well with the international evidence showing that the stabilization of a hyperinflation is often more rapid than the stabilization of chronic inflation.[19]

Impact on Investment and Growth of Reform. The stabilization and adjustment programs in the three countries came along with an initial output contraction though the degree of the output decline varied in each case: GDP fell by around 12-15 percentage points in the recessions of 1975 and 1982-83 in Chile; output contracted (cumulatively) by nearly 5 percent in Mexico in 1982-83 and in

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[19] See Sargent (1982), Dornbusch and Fischer (1988), Solimano (1990a).

Table 2. Indicators of Speed of Adjustment - Latin America

	Number of Years for Inflation to reach the threshold of 20-25 percent per year[a]	Number of Years for Private Investment to Recover to Sustained Levels (more than 3 years of consecutive Expansion)
Chile[a]		
1974-89	7 years	5 years
Mexico		
1982-91	7 years	6 years
Bolivia		
1985-91	2 years	--

[a] Counting from the stabilization plan of 1975.

Bolivia it fell by 2.5 percent in 1986. In all these episodes, these economies suffered also negative external shocks.

Regarding investment, the experience of Chile in the 1970s and Mexico in the 1980s is that public investment tends to suffer in the initial phases of an adjustment program. In Chile, between 1976 and 1984 public investment was maintained around 3 to 4 percentage points of GDP below its level of the sixties. In Mexico, public investment declined by nearly 5 percentage points of GDP in the period 1982-89 as compared to 1978-81. In contrast, public investment started to recover in Bolivia after the program of 1985.

The response of private investment to the reform process in the three countries was mixed.[20] In Chile, private investment increased strongly in the second half of the seventies, to drop sharply during the recession of 1982-83 and recover a few years later. In Mexico, private investment declined from 1981 to 1983, then it remained virtually stagnant until 1987, recovering afterwards. In Bolivia, private investment was declining before the program in the first half of the eighties. That decline stopped with the launching of the adjustment program in 1985; however, it remained quite depressed afterwards (see table 2).

Distributive Impact. An important and contentious issue is the impact of the adjustment programs on poverty and income distribution. Table 1 shows that in Chile (1971-73) and Bolivia (1982-85) real wages were **falling** before the adoption of the stabilization programs. In general, the rapid escalation of inflation before reform in these two countries was the main cause of the decline in real wages. Thus, stopping high inflation becomes a condition **sine qua non** for reversing a negative trend in real wages. However, real wages remained depressed for a long while in Chile; in fact, the average real wage was still lower in 1989 than in 1970. In addition, during most of the Pinochet regime the average rate of unemployment was more than two times

[20] A detailed analysis of the cycle of private investment in adjustment programs appears in Solimano (1992).

higher, on average, than the rate of unemployment of previous decades. This suggests that low-income groups bore a large share of the costs of adjustment in Chile.

Several indicators portrayed in tables 3 and 4 convey useful information on the distributive consequences of the policies applied in Chile after 1974. The Gini coefficient increased (greater inequality) by around 4 points (a non-negligible amount) between the late sixties and the early 1980s. In addition, the share in consumption for the lowest 40 percent income group declined steadily both in 1978 and 1988 compared with 1969 (Meller, 1991). These effects were meliorated in part with an improvement in some social indicators. There was a decline in the rate of infant mortality (now one of the lowest in Latin America) and in different indicators of malnutrition as a consequence of an increasing targeting of some social programs to more vulnerable groups in extreme poverty.

In Mexico, the adjustment policies started to be implemented after 1982 had a negative impact on total labor incomes and particularly on real wages (Lustig, 1992). Real wages in manufacturing declined by a cumulative 38.5 percent in the period 1983-88, with an even larger decline of real wages in the public sector (table 5). Nevertheless, real per capita consumption declined by 11.5 percent over the same period suggesting that non-wage incomes (of the poor and the rich) must have declined by less than wage incomes.[21] Regarding the evolution of social expenditure in Mexico shows a decline of around 1.0 percent of GDP in social spending in education per capita between 1981 and 1989 and a reduction of 1.6 percent of GDP in expenditure in health over the same period (Lustig, 1992).

To sum up, the review of three Latin American experience with market-based economic reform in the 1970s and 1980s shows that reforming distressed economies is a long process. Putting the "house in order" in macroeconomic terms is not easy. In the cases reviewed, stabilizing inflation took longer

[21] Non-wage income recipients include low income groups in the rural and the urban informal sectors (self-employed workers, small enterprises, the workers employed in the service sector).

Table 3. Trends in income distribution in Chile for selected years, 1969-84

Period	Gini coefficient of family income (1)	Share of income: Lowest 40% (2)	Middle 40% (3)	Highest 20% (4)	SEN indicator (5)	Real wage indicator (6)	Unemployment rate (%) (7)
1969-71	0.493	11.5	32.7	55.8	19.0	100.0	5.5
1979-81	0.523	11.1	31.4	57.6	17.6	89.6	16.5
1982-84	0.543	10.0	30.6	59.5	28.3	90.5	27.4

Source: Meller (1991)

Table 4. Household consumption by income group in Santiago, Chile—1969, 1978, and 1988 (percentage)

Income group	1969	1978	1988
Lowest 40%	19.4	14.5	12.6
Middle 40%	36.1	34.5	32.8
Highest 20%	44.5	51.0	54.6
Total	100.0	100.0	100.0
Average monthly household consumption (1988 pesos)	75,535.0	76,260.0	76,094.0

Source: Meller (1991)

Table 5. Mexico -- Distributive Indicators

	Cumulative change in: Total wage income (percent)	Real wages: Industrial sector (percent)	Real wages: government sector (percent)	Private consumption per capita (percent)
1983-88	-39.7	-38.5	-46.1	-11.5

	Share of non-wage income in national income* (percent)
1980	61.4
1989	72.7

*(includes urban informal sector, and agricultural self-employed income)

Source: Lustig (1992)

than anticipated and involved considerable costs in terms of real economic activity and real wages. Moreover, the transition to sustainable growth in the aftermath of stabilization is cumbersome. Public and private investment tend to suffer in the initial phases of an adjustment program. Moreover, a sustained recovery of private investment after a large initial contraction may take several years.

Regarding the distributive impact of adjustment programs, the available evidence shows that adjustment policies (compounded by negative external shocks) involved cuts in real wages and/or increases in unemployment rates in Chile, Bolivia and Mexico, making low-income groups to bear a large share of the adjustment burden. On the positive side, the expansion of non-traditional exports and the discipline of enhanced foreign competition on the domestic economy are valuable effects of the reforms.

5. Radical Economic Reform in Eastern Europe after 1989

The current attempts in Eastern Europe to transform socialist economies based in state ownership and central planning into market economies is perhaps one of the most ambitious attempts at economic reform in modern times. Far worse, there were practically no previous experience with economic transformation of this magnitude.[22]

Free-market experiments of economic reform started in 1990, following the political collapse of the socialist regimes. This process is very complex given that the initial conditions of these economies are particularly poor in terms initial macro imbalances, pervasive micro-distortions and oversized public sectors. In addition, the reforms are taking place in emergent democracies with a considerable degree of political fragmentation.

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[22] Attempts at partial economic reform are much older in Eastern Europe. Hungary started with set-backs a program of economic decentralization and gradual "marketization" in 1968. Poland and Yugoslavia also tried reforms in the early 1980s though those programs were seen as reforms within the existing economic system rather than as reforms to **replace** the socialist regime for a market economy.

Country Programs

Poland launched in January 1990 the first comprehensive program to establish a market system in Eastern Europe.[23] The Polish program combined fiscal austerity with price deregulation, trade liberalization and privatization.

The Polish economy started its program of economic reform with large macroeconomic imbalances, shortages in consumer goods markets and a large stock of external debt. Inflation was 640 percent in 1989, following large devaluations coupled with wage increases in 1988-89. GDP growth slowed-down in the 1980-88 (see table 6) and turned negative, -1.4 percent, in 1989. The current account deficit in convertible currency was 2.5 percent of GDP in 1989 and debt servicing, represented near 56 percent of merchandise exports in 1990.

The program of January, 1990 entitled the dismantling of most price controls and sharp increases in energy prices and public tariffs. The exchange rate was fixed at a substantially depreciated level and the zloty was made convertible for current account transactions. Tariffs and other quantitative restrictions to international trade were rapidly eliminated.

On the fiscal side a reduction of the fiscal deficit on the order of 7 percent of GDP was planned though much less was actually attained. Monetary and credit policy was tightened and a tax on wages was instituted in order to prevent wage increases granted by enterprises to exceed government guidelines.

Privatization was initiated by selling restaurants, shops in the trade sector and small-size enterprises. However, little progress has been made in the privatization of large state owned public enterprises, in spite of the proliferation of sophisticated schemes deviced for that purpose.

[23] A growing literature on the Polish case exists nowadays. See Lipton and Sachs (1990a), Sachs and Berg (1991), Calvo and Coricelli (1991).

Table 6

East-Central Europe: Economic Indicators

		Growth Rates (percent) a/					Inflation (percent year end)			Current Acct./GDP (Conv. Curr.) (percent)			Ext. Debt/GDP (Conv. Curr.) (percent)
	GDP $Bil	NMP		GDP									
Countries	1990	1970-80	1980-88	1989	1990	1991	1989	1990	1991 a/	1989	1990	1991 b/	1990
Bulgaria	22.4	7.0	4.4	-1.4	-10.2	-26.0	6.3	64.0	430.0	-6.4	-2.7	0.0	40.2
Czechoslovakia	46.5	4.7	2.0	1.3	-3.5	-16.4	1.3	13.9	49.0	0.9	-1.0	-5.1	16.5
Hungary	32.1	4.5	1.3	-0.9	-6.5	-7.8	18.0	30.0	32.0	-4.9	-0.2	1.0	62.2
Poland	62.3	5.4	1.0	-0.5	-14.0	-9.0	640.0	249.0	60.4	-2.7	-2.5	-1.2	74 3
Romania	35.5	9.3	4.7	-5.8	-10.2	-10.0	2.5	27.0	184.0	5.4	-3.9	-4.8	5.6

a/ January-November.

b/ Cash basis. The current account on an accrual basis was -7.5 percent in Bulgaria (due to arrears on foreign debt servicing).

Source: World Bank

Czechoslovakia started its program of economic reform in 1990 with apparently small macro imbalances, no money overhang (Bruno 1992) and a low level of external debt (the ratio of foreign debt over GDP was 19 percent in 1990).[24] In the 1980s, Czechoslovakia decelerated growth sharply, though maintaining low open inflation. The program in Czechoslovakia inv lved a stepwise deregulation of controlled prices in 1990, followed by a complete elimination of most price subsidies and controls in early 1991. In addition, fiscal policy was restrictive as well as credit and wage policy. After a substantial initial devaluations of the crown Czechoslovakia pegged the exchange rate as a nominal anchor. Like in Poland, privatization took place at a fast pace at the level of retail trade and services. A massive plan for auctioning shares, through a voucher system, of 1,200 state-owned enterprises to more than 8.5 millions of citizens is to be launched by early June of this year.

Hungary started its reforms already in 1968 though they were partial and with setbacks. By 1982 nearly half of the prices for consumer goods were free, a proportion that went up to 80 percent in 1990. In addition, private property in housing and small scale enterprises was in effect in the 1980s, accompanied by new tax and banking laws. Hungary was caught in the late 1980 with almost no monetary overhang; however, its level of external debt was high (65 percent of GDP in 1990). In early 1991 the exchange rate was devalued by 15 percent and additional consumer goods prices were freed in the context of fiscal, monetary and wage restraint. The exchange rate regime followed a fixed peg.

Bulgaria, an agrarian economy before socialism, industrialized and become strongly dependent in its foreign trade with the Soviet Union under a highly orthodox socialist regime. Bulgaria started its reform program in 1990 with a

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[24] Historically, Czechoslovakia was characterized by a prudent macro management. Czechoslovakia avoided hyperinflation (unlike Austria, Germany and Poland) in the early 1920s and also suffered mildly from the depression of the early 1930s as it had accumulated little external debt in previous years; see Solimano (1991).

large monetary overhang, repressed inflation and a high level of external debt, mostly accumulated during the second half of the eighties.[25]

Price reform started piecemeal in 1990, though it accelerated in February of 1991 when most price controls were abolished, subsidies phased out and the exchange rate left floating (due to the lack of international reserves to support a fixed parity). The ensuing exchange rate depreciation was huge, 500 percent, and it produced a price hike of vast proportions (see next section). Current account convertibility was introduced and trade taxes sharply reduced. In addition, wage and credit policy turned very tight. Plans for privatization are underway and some progress has already taken place in retail trade and services.

Romania entered the process of economic reform after the violent overthrown of Nicolae Ceausescu in late 1989. In spite of some independent stance in foreign policy regarding the USSR, the economic policies followed by the Ceausescu regime were extremely orthodox (in a socialist sense). The trend toward some decentralization and reform of the other socialist countries in the 1980s and before, never reached Romania.[26] On the contrary, the tendency was towards further centralization and deepened central planning. In the eighties, the Ceausescu regime followed a deliberate policy of paying -- even prepaying -- its external debts at almost any cost. For that purpose the country was running increasing trade surpluses by compressing consumption, investment and imports. Moreover fiscal surpluses were increased through the curtailment of social spending, further squeezing living standards. At the end of the regime the external debt of Romania was almost nil though the economy was in shambles.

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[25] See Solimano (1991b).

[26] See Demekas and Khan (1991).

Price liberalization took place in three rounds: November 1990, and April and July of 1991.[27] Currently, near 80 percent of prices are determined in the market. The exchange rate was devalued in each of these rounds, jumping from 20 leu per dollar before november 1990 to 60 leu after the last adjustment, thus accumulating a nominal devaluation of 300 percent in near 8 months. The exchange rate was left floating and to be determined in an interbank market, with the exception of some basic imports. The trade regime has been reformed through abolishing the state monopoly on international trade and by eliminating quantitative restrictions and reducing the average level of tariffs to the range of 10 to 30 percent. On the fiscal side the forced profit remittance system was replaced by a corporate income tax. A new privatization law was enacted in 1991, though with little progress so far in encouraging actual privatization.

Initial Results and Performance

Two years or less of economic reform in Eastern Europe is obviously a very short period to make a thorough assessment of policy performance. However some common features from the experience in Eastern Europe are starting to emerge. Price reform produced an immediate and often sharp increase in the price level. In most of these countries, the price hike in general exceeded what was expected.[28]

Poland and Bulgaria experienced the sharpest increases in prices following the lifting of price controls and elimination of subsidies. The CPI in January of 1990 increased by 77 percent in Poland. In Bulgaria inflation was 110.1 percent in February, and 46.7 percent in March. Hungary avoided a major price jump and in Czechoslovakia the CPI increased by near 26 percent in January 1991 following price adjustments. In Romania, prices increased by near 25 percent in the first month after price liberalization (table 7).

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[27] See Demekas and Khan (1991).

[28] See Bruno (1992).

Table 7

East-Central Europe: CPI Monthly Inflation Rates (percent)

	Bulgaria	Czechoslovakia	Hungary	Poland	Romania
1990					
January	0.8		15.4	77.3	-
February	0.8	2.4	2.9	15.8	-
March	0.7		1.2	4.7	-
April	0.8		1.9	6.6	-
May	0.8	0.8	0.2	4.5	-
June	3.5		-0.1	3.8	-
July	3.4		2.2	4.9	-
August	16.6	10.0	3.2	1.8	-
September	4.5		1.3	4.6	-
October	4.2		1.0	5.7	-
November	5.4	4.3	1.0	4.9	23.4
December	10.2		-0.1	5.9	11.6
1991					
January	14.4	25.8	7.5	12.7	14.8
February	110.1	7.0	4.9	6.7	7.0
March	46.7	4.7	3.7	4.5	6.6
April	3.6	2.0	2.4	2.7	26.5
May	2.5	1.9	2.1	2.7	5.1
June	7.4	1.8	2.1	4.9	2.0
July	9.8	-0.1	0.9	0.1	9.5
August	5.0	0.0	0.2	0.6	11.2
September	4.2	0.3	1.5	4.3	7.3
October	3.8	-0.1	1.3	3.2	10.4
November	5.1	1.6	1.4	3.2	10.9

Sources: IMF staff estimates.

Another important issue is the degree of **inflationary persistence** after the initial outburst of inflation. Table 7 shows that persistence is relatively important in Poland, Bulgaria and Romania and less so in Czechoslovakia and Hungary.

Apparently, there is considerable cross-country variation in the extent of inflation acceleration following price decontrol, and adjustment in the exchange rate and public tariffs; see figures 3a-b. These differences seem to reflect different initial macro imbalances and the size of the money overhang existing before price reform. Regarding monetary accommodation and wage indexation, a common feature of the East European stabilization programs implemented since 1990 has been a stance of restrictive monetary and credit policies supplemented with wage repression (or de-indexation). An important medium-term issue refers to the rate of inflation that this post-socialist economies will converge after the stabilization period (assuming it succeeds); in particular, whether the inflation rates in Eastern Europe will converge to OECD-levels (single-digit rates) or to approach inflation-rates of successful non-OECD stabilizers like Mexico, Chile, Israel, namely to annual rates around 20 percent.

On the real side, the adjustment programs in Eastern Europe have been accompanied by unprecedent output contraction; see figures 4a-e. In Poland GDP fell by 12.5 percent in 1990, and by an additional 9.0 percent in 1991 completing a cumulative decline of the order of 20 percent in two years. The magnitude of the output losses has been even larger in Bulgaria where GDP fell by 10.2 percent in 1990 and by an extra 26 percent in 1991; namely a cumulative drop of output of over 35 percent in two years!. In Czechoslovakia GDP fell by -3.5 percent in 1990 and by -16.4 percent in 1991. In Hungary the drop of GDP was -6.5 percent in 1990 and -7.8 percent in 1991.

In an international perspective, the extent of the contraction in measured economic activity in Eastern Europe since 1990 is much greater than the corresponding declines in output initially observed in Chile, Mexico, Bolivia after the implementation of their stabilization programs.

The extent of output contraction in Eastern Europe has to be qualified, somewhat, since it mostly reflects the decline in economic activity in the socialized sector. Casual and anecdotal evidence suggests that a burgeoning private sector is emerging in the services and retail sectors. However, since the state sector is still (and it is bound to be for many years) the dominant one, the decline in GDP is a worrisome trend. Moreover, there is a slow but persistent increase in unemployment in Eastern Europe which already exceeds 11 percent in Poland and Bulgaria.

Several hypothesis are being put forward to explain the current drop in output in the region: (i) Demand contraction as part of the stabilization effort. The combination of tight credit and fiscal policies as well as large drops in real wages lead to a decline of effective demand and a drop in output in Keynesian fashion;[29] (ii) Adverse supply and organizational shocks. The dismantling of central planning has involved a disruption of the traditional supply networks of inputs and capital to enterprises, thus contributing to the decline in production. A context of high uncertainty on the future rules of the game regarding the property structure has also a discouraging effect on worker effort and managerial motivation. At a macro level, another adverse supply side effect comes from a crunch in the supply of working capital (Calvo and Coricelli, 1991); (iii) External shocks associated to the disintegration of the CMEA. The elimination of the subsidies in soviet exports to CMEA countries typically oil, coal and other forms of energy amounted to a terms of trade shock for Eastern Europe with the ensuing adverse real income effect[30]. (iv) Too rapid trade liberalization. A rapid switching in domestic demand towards foreign goods has recessionary results in the short-term since a sizeable shift to exports to western markets is unlikely to take place in a

[29] Berg and Sachs (1992) argue that demand contraction, in the context of the stabilization program, has been the main cause behind the drop in GDP in Poland in 1990-91.

[30] The response to the terms of trade shock has been a mix of adjustment and financing; the latter is from multilateral and bilateral official sources besides some private capital inflows.

short period of time, in spite of highly competitive exchange rates (quality problems, particularly, in manufacturing are serious).[31]

Regarding the social costs of reform in Eastern Europe, the current experience shows that adjustment is involving large cuts in real wages and a slow but steady upward trend in unemployment. The medium-term outlook may be gloomy as a rapid turn around in the decline in aggregate output in the state sector is not in sight, and the restructuring process in the state owned enterprises has barely started. The current rise in economic insecurity and "adjustment distress" is making the politics of the transition very complicated; bringing the shadow of a slide back to authoritarianism and/or populism quite real.

[31] See Mc Kinnon (1991) for an argument in favor of gradualism in trade reform in post-socialist transitions.

Figure 3a
Monthly Inflation Rates
in Czechoslovakia, Hungary and Romania
(1990.1-1991.11)

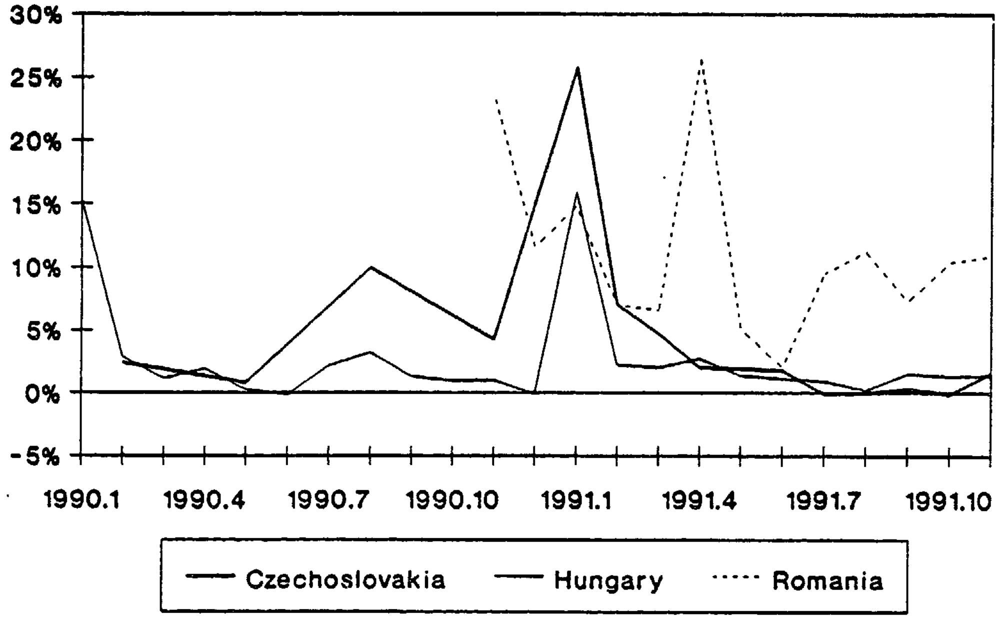


Figure 3b
Monthly Inflation Rates
in Bulgaria and Poland
(1989.2-1991.12)

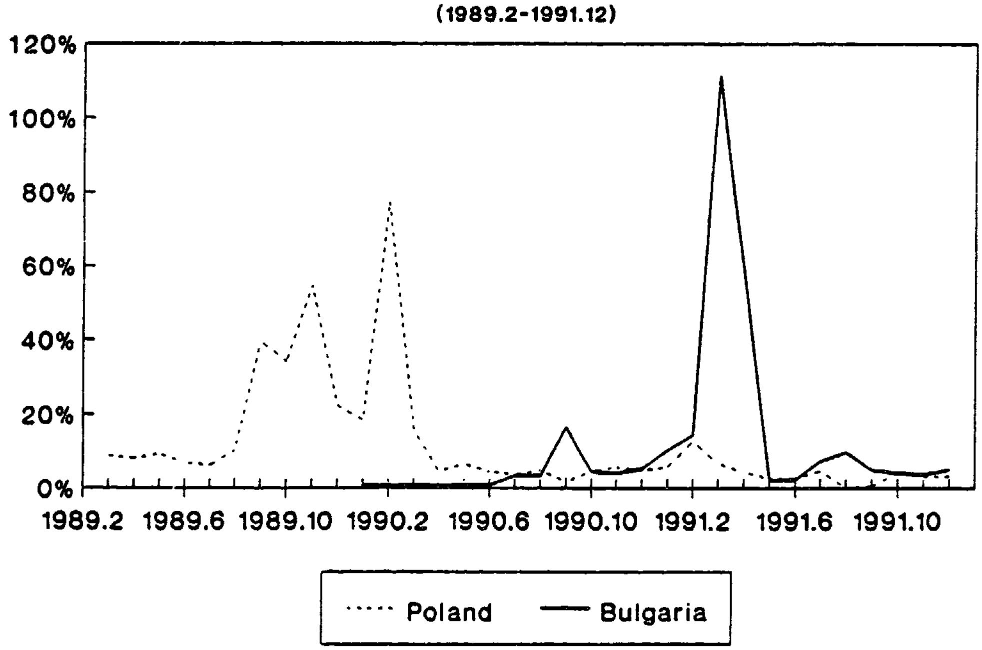
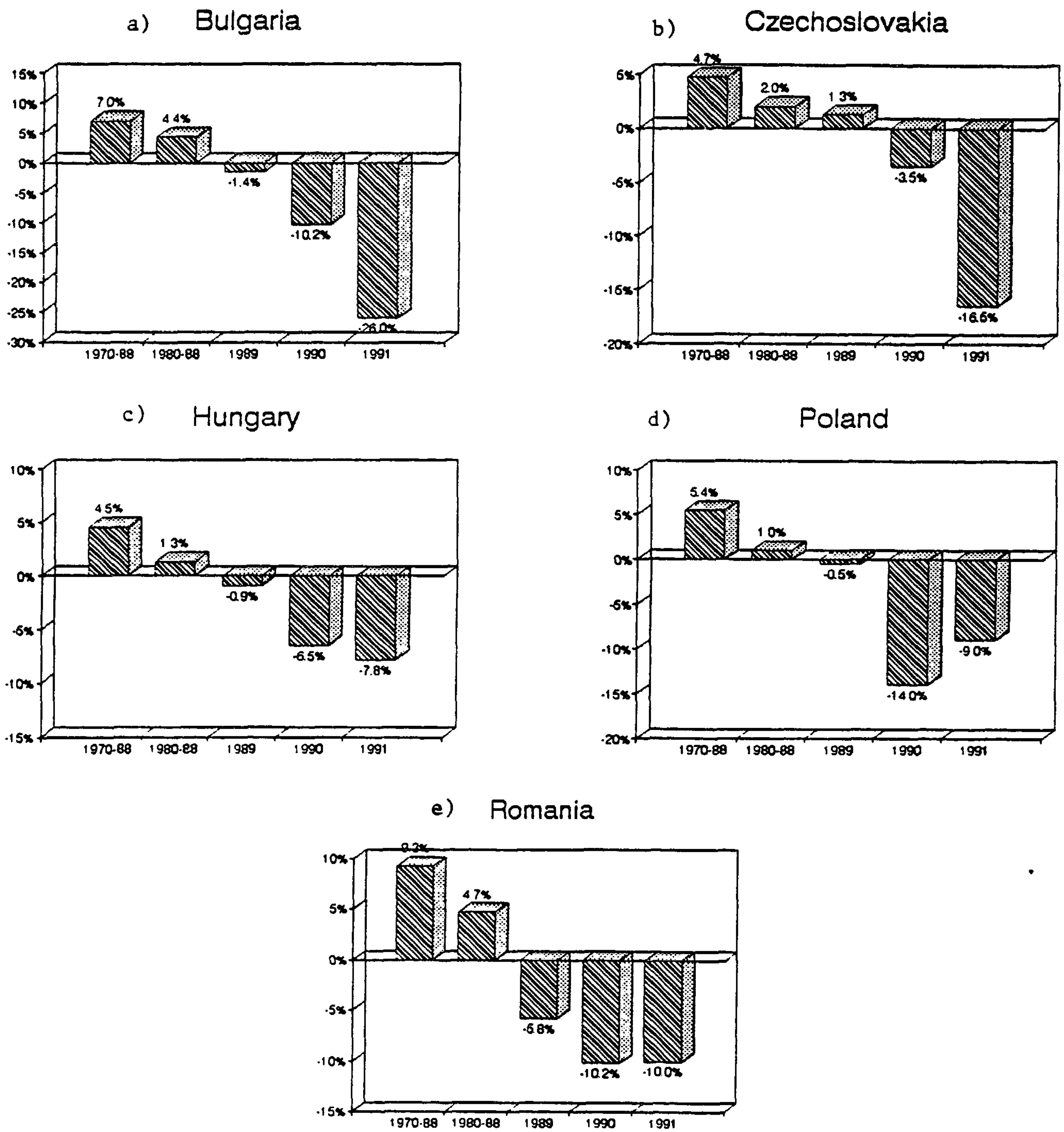


Figure 4 a–e
GDP GROWTH RATES IN EASTERN EUROPEAN COUNTRIES



Note: Figures for 1970-80 and 1980-88 refers to Net Material Product growth rates.

6. Gradual Economic Reform I: Korea

The East Asian experience, of the last three decades particularly the case of Korea, is an extremely interesting case of highly dynamic development based in export growth and high levels of capital formation. Korean policies were pursued in a context of active, but competent, state intervention and stable macro environment.[32] Korea embarked after 1962 in an aggressive strategy of investment cum export led-growth. The new program of economic transformation reform combined orthodox policies of exchange rate management to increase exports while liberalizing imports. Policies relied, in a planning fashion, in a series of five-year plans oriented to boost industrialization with active support from credit and exchange rate policies. Foreign aid was substituted by increased domestic savings and foreign borrowing. The results were remarkable as GDP grew at an annual rate of 10 percent per year between 1965-1973 while exports were expanding at an annual rate of 40-50 percent between 1960-73 (Collins and Park, 1989). In 1973, the Korean government launched a "Big Push" oriented to increase investment in heavy and chemical industries, while introducing additional import restrictions and new credit controls. These policies allowed rapid growth, though the excessive investment drive and government subsidies led to increasing inflationary pressures and a loss of external competitiveness.

The problems with heavy industrialization and accelerated inflation, compounded by the second oil shock forced the adoption of adjustment measures in 1980-81. Monetary policy become tighter, the fiscal budget deficit was reduced from 4.7 percent of GDP in 1981 to 1 percent in 1985, imports were liberalized in a selective way, and regulations over the financial system and foreign direct investment lifted gradually. A new period of rapid growth, low inflation and current account surplus took place since the mid-eighties.

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[32] Excellent analysis of the Korean experiences are Collins and Park (1989), Dornbusch and Park (1987), Amsden (1989).

Table 8

Korea
Economic Indicators

	1963/73	1974/80	1981/86	1987/90
Inflation	17.1	22.9	6.6	5.9
Real GDP growth	9.5	7.3	9.2	10.3
Manufact. Production	19.7	14.1	10.0	10.8
Share in GNP				
Agriculture	35.2	21.5	14.0	10.7
Manufacturing	15.7	28.1	31.4	32.1
Other	49.1	50.4	54.6	57.2
Exports as share of GNP	13.2	30.6	37.3	37.3
Investment as share of GNP	20.0	29.2	29.5	31.9
Foreign Saving share of GNP	8.3	7.4	3.9	-3.4
Domestic Share share of GNP	11.7	21.8	25.6	35.3

Source: IFS, IMF -- World Tables. World Bank.

Regarding **macroeconomic stability**, Korea managed to keep inflation in the range of 15-20 percent per year during the sixties ard seventies. After the stabilization of 1980-81 inflation was reduced below 10 percent. In general, Korea avoided the kind of macroeconomic crises so common in Latin America, even though during 1980-81 inflation accelerated and GDP growth slowed down sharply. Korea ran large current account deficits -- of the order of 8-9 percent of GDP -- in the late sixties, in 1974 and in 1980-81, though it managed to correct them without compromising GDP growth, in a major way. In addition, fiscal imbalances never reached large proportions and the budget was kept, in general, under control. Besides the episode of currency overvaluation of the late seventies, the exchange rate policy, along with active credit policies, were directed to enhance external competitiveness and boost export growth. In short, the process of economic development in Korea, has unfolded without large shocks and destabilizing macroeconomic crisis.

In relation to the **investment and growth performance**, what is striking of the Korean experience is its ability to sustain very high growth rates, on the order of 8 percent per year, for nearly three decades. Behind that strong growth performance we find an impressive investment drive with rates of capital formation on the order of 30 percent of GDP in the 1970s and 1980s. In addition, the Korean economy was able to mobilize domestic savings effectively to support the effort at capital formation by raising the domestic saving rate from near 6 percent of GDP in 1963 to 30 percent in 1985 (Collins and Park, 1989). This growth performance, did not take place in a laissez-faire regime. Governments encouraged export growth and investment using, for a long time, trade restrictions, directed credit intervention and increased taxation in a context of close cooperation with business conglomerates; though government intervention avoided the anti-export bias of most Latin American cases. Finally, another factor behind the strong growth performance of Korea is her ability of maintaining high rates of productivity growth. Like other "late industrializers" Korea pursued a deliberate policy of borrowing advanced foreign technologies to enhance competitiveness and growth (see Amsden, 1990).

An interesting feature of the Korean model is that **income distribution** was maintained relatively equitable during the transformation process unless compared to the standards of other developing countries, particularly in Latin America. In fact, the share in national income of the bottom 40 percent of the population in Korea is higher than the corresponding ratio in countries like Brazil, Mexico, Thailand and Hong Kong. Moreover, the income share of the top 20 percent is lower in Korea than the corresponding share in Brazil, Mexico, Thailand and Hong Kong.

The agrarian reform undertaken in the late forties has been identified as one of the most important factors in the relatively egalitarian income distribution of Korea (Collins and Park, 1989). Another major factor in this direction has been a sustained effort of improvement in the educational levels of the population and labor force since the sixties.[33]

Regarding the political economy of the Korean model, the program of economic transformation started in the early sixties was launched by a military regime, led by General Park Chung Hee, that took power in a coup in 1961 and remained president until 1979. In the 1980s the military still run the country though the system started to implement measures of political liberalization towards the mid to late eighties.

7. Gradual Economic Reform II: China

China's experience with economic reform following the death of Mao Dze Dong and the abandonment of the policies of the cultural revolution of the period 1966-76 represent a quite different pattern of economic reform of that followed in Eastern Europe in the last two years. First, in China, the process of economic reform was impulsed "from within" the socialist regime. It was the leadership of the communist party that got convinced that moving away from central planning was needed in order to accelerate economic growth

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[33] Secondary enrollment,as percent of age group, increased from 35 percent in 1965 to 89 percent in 1988.In addition, the percentage of higher education, with respect to the age group went up from 6 percent in 1965 to 37 percent in 1988. See World Development Report, 1991 (World Bank, 1989).

and improve the standards of living of the population. Unlike Eastern Europe, economic reform in China was not the natural corollary of a political crises of the whole socialist system. Second, the economic reform process in China was not openly envisaged as the replacement of the socialist economic model by a market economy based in private property. Socialism was never officially dismissed in China and public property has not been officially challenged. Third, economic reform was perceived as a gradual process of increasing coexistence between markets and the state with a great concern on maintaining price stability and macroeconomic balances over the rapid achievement of liberalization policies. Fourth, the structural characteristics of the Chinese economy at the starting of the reform process makes it very different from the economies of Eastern Europe. China is a large economy with a population above 1 billion, with a large agricultural sector and belongs to the group of countries with a low level of per-capita income, say below 500 dollar.[34] In addition, unlike Poland or Bulgaria and Romania, China started its program of reform in the late 1970s with low **open** inflation and no clear monetary overhang.

The program of economic reform started in 1978 with a deregulation of the agricultural sector (the "household responsibility system").[35] This implied an increase in agricultural procurement prices paid by the state, allowing farmers to sell their production surpluses in free markets after delivering a pre-determined quota to the state. In addition, they were allowed to retain profits. This led to flourishing agricultural activity and the growth of small scale enterprises in rural markets and townships. Starting in 1984, an "enterprise responsibility system" was established for state enterprises in the industrial sector. The system comprised a dual or two-tier price scheme. Like in agriculture, state owned enterprises were

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[34] The World Development Report of the World Bank puts the GDP per capita of China in US$ 350 in 1989.

[35] Good references on the Chinese experience with economic reform are: Perkins (1988), Blejer, Dunaway and Szapary (1991), Hussain and Stern (1991), Schmidt-Hebbel and Xu (1991).

allowed to sell at market-determined prices the excess of output over the quota delivered to the state agency.[36] In 1986, the system of compulsory remittance of profits to the central government was abolished and a corporate income tax of 55 percent was instituted. The rationale was to accept the profit motive in the behavior of public enterprises in order to promote efficiency and decentralization. As of 1991, around 50 percent of prices are determined in unregulated markets (Schmidt-Hebbel and Xu, 1991). On other fronts, "special economic zones" were created, mostly in the south of the country near other East Asian markets. In these "special economic zones", particularly in the Guangdon and Fujian province, direct foreign investment, oriented to export processing, receives special treatment for profit remittances and tax obligations. The basic aim of those special zones is to attract foreign investment and expose segments of the economy to foreign competition and get access to new technologies and markets.[37]

In contrast with other experiences of economic reform the Chinese process has evolved in a context of relative **macroeconomic stability**, albeit punctuated by periods of inflationary acceleration following price reforms. In particular, inflationary outbursts took place in 1980-81, 1985-87, and 1988-1989. The most serious acceleration of inflation was in 1988-89 when the retail price index rose to near 20 percent on an annual basis (see figure 5b). Inflationary pressures were, in part, compressed: subsidies for consumer agricultural goods increased from 0.3 percent of GDP in 1978 to around 4.0 percent in 1984. As of 1991 the price subsidies on consumer goods still represent around 1.5 percent of GNP (Schmidt-Hebbel and Xu, 1991). At the macro level, the policy response to outbursts of inflation observed after the periods of price reform have been one of tightening credit policy and restraining wage increases in state owned enterprises. In general the Chinese

[36] See Schmidt-Hebbel and Xu (1991).

[37] See Perkins (1992).

government seems to have a genuine distaste for inflation.[38] Table 9 shows that the fiscal deficit (central government) has been maintained at a relatively modest level throughout the reform period, say around 2.0 percent of GDP during 1978-1991.[39] Moreover, it is interesting to note that fiscal deficits tended to widen during the periods of price reform. In particular, the share of subsidies on operating losses of state-owned enterprises increased after 1986, as the enterprises sector moved towards greater decentralization and away from forced profit remittances; in fact the share of subsidies to state-owned enterprises went up from 1.3 percent of GNP in 1978-85 to 3.5 percent of GNP, on average, in the period 1986-91 (Schmidt-Hebbel and Xu, 1991). Finally, on the external sector China enjoyed a relatively comfortable position during the reform process with considerable levels of international reserves (as share of imports) and with moderate, though increasing, levels of external debt (table 9).

The response of the Chinese economy to the reforms started in the late seventies was impressive, in terms of **output growth** (see table 9 and figure 5a). Average GDP was growing at 8.7 percent per year in the period 1978-1991. In contrast, the rate of growth of national income in the period 1970-77 was 4.6 percent (Hussain and Stern, 1991). In the period 1978-91 GDP per capita grew 7.3 percent per year with a similar trend in per-capita consumption; clearly the standards of living of the population increased drastically over the reform period; though they are still at a low level, as proxied by the level of income per capita.

To summarize, the Chinese reform process has been gradual, conservative in macroeconomic terms and apparently it has preserved the gains in social welfare and distribution achieved in the pre-reform period (see Perkins, 1988). In contrast with the recent experience of Eastern Europe, the economic

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[38] This may have historical roots as China experienced a virulent hyperinflation in the late forties at the time of the revolution.

[39] Unfortunately data on the quasi-fiscal deficit of the central bank is not yet available for China.

Table 9
China -- Main Economic Indicators

	(1) Growth rate, GDP (a) Total	(1) Growth rate, GDP (b) Per Capita	(2) Agriculture output (growth rate percent)	(3) Inflation Rate (a) GDP deflator (percent)	(3) Inflation Rate (b) Retail Price Index (percent)	(4) Budget Deficit (percent of GDP	(5) International Reserves (months of imports)	(6) External Debt (percent of GDP)
1971-77	4.6[a]		1.6		0.4			
1978	12.3		3.4		0.7	-0.3	4.9	0.29
1979	7.2	5.8	6.4	3.6	2.0	5.2	6.7	0.85
1980	7.9	6.6	-1.8	4.0	6.0	3.3	6.1	1.51
1981	4.5	3.2	7.1	2.2	2.4	1.3	5.5	2.07
1982	8.7	7.1	11.7	0.1	1.9	1.4	10.7	3.05
1983	10.1	8.7	8.5	1.4	1.5	1.7	11.1	3.28
1984	14.5	13.2	13.0	4.6	2.8	1.6	9.3	4.04
1985	13.0	11.7	1.7	9.1	8.8	0.5	4.8	5.74
1986	8.4	7.1	3.7	4.6	6.0	1.9	4.6	8.45
1987	11.2	9.9	4.8	5.0	7.3	2.0	6.2	11.60
1988	10.8	9.5	3.2	11.5	18.5	2.6	5.2	11.27
1989	3.9	2.6	3.3	9.0	17.8	1.8	5.1	10.03
1990	4.9	3.6	6.9	4.9	2.1	1.5	7.7	14.40
1991	5.0	3.8	3.5	-	3.0	-	7.5	15.32
Average: 1978-1991	8.7	7.3[b]	5.4	5.0[c]	5.8	1.9	6.8	6.6

Source: World Bank. Schmidt-Hebbel and Xu (1991)

Notes: [a] Net national income. Hussain and Stern (1991).
[b] 1979-1991.
[c] 1979-1990.

Figure 5a

Real GDP in China

(1985=100)

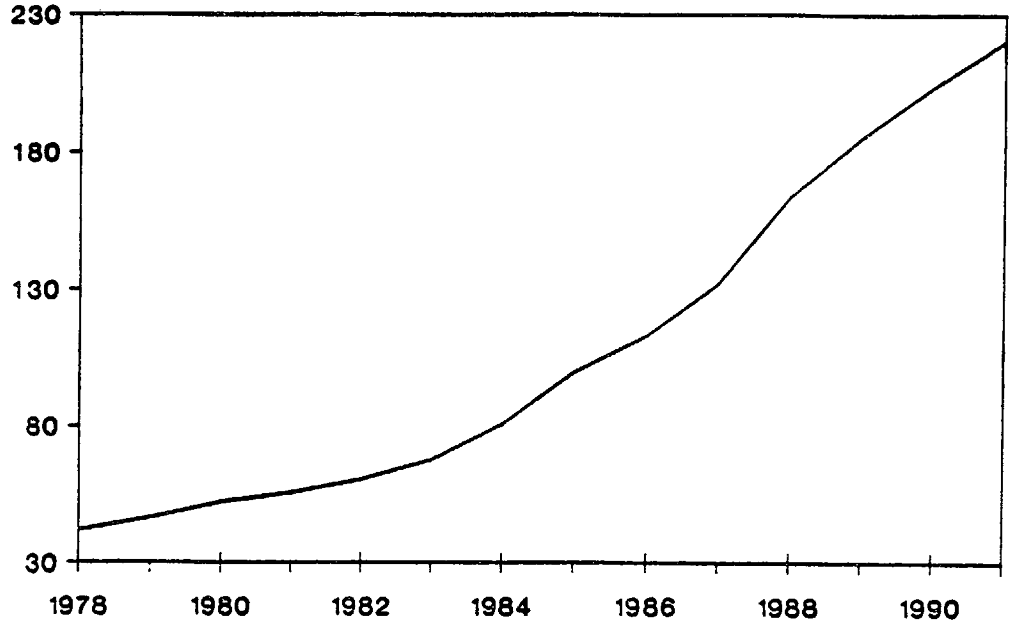
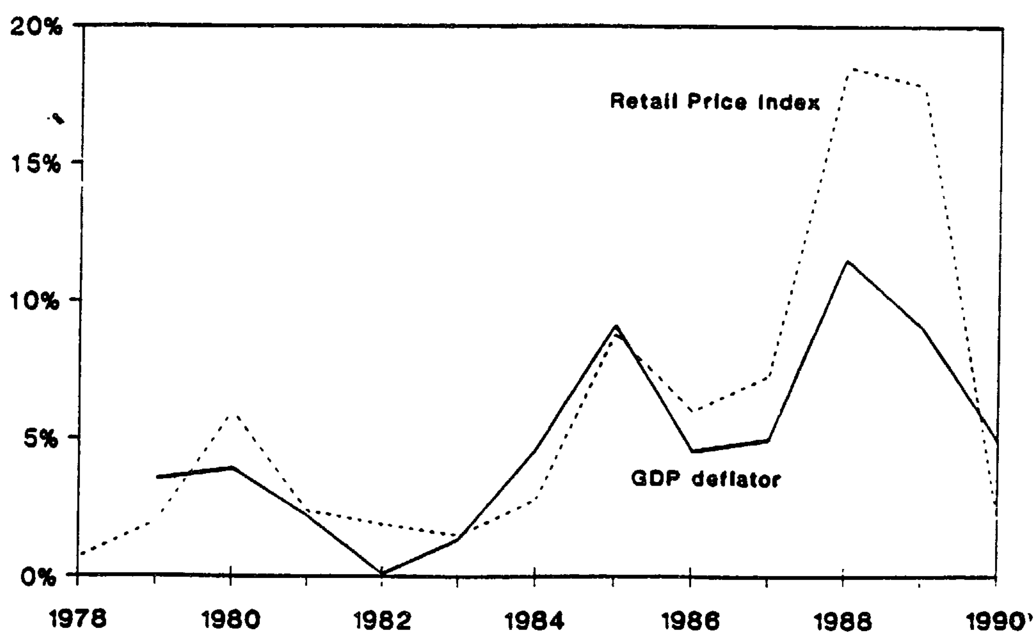


Figure 5b

Annual Inflation Rate in China

(1980=100)



reforms in China have taken place without serious macroeconomic dislocation. Nevertheless, the reforms are still partial: near half of the economy still operates under controlled prices, and national wealth is almost completely in the hands of the state.

8. Summing-Up

Prior to summing-up the main findings of this paper, a caveat is in order. It is apparent from this review of experiences on reform that a blueprint of universal validity, on "how to reform an economy" simply does not exist, given the enormous country diversity in initial conditions, structural features of the economy and political conditions that are bound to exist at the start of a process of reform. Broad generalizations on preferred policies have necessarily to be complemented by a knowledge of the specific economic conditions and the political realities of the country entering into a process of reform. Nevertheless, some broad generalizations are apparent, as described below:

(i) **Reform Strategy: Shock versus Gradualism.** It is clear that the choice between these two alternatives will be greatly influenced by two elements: the initial conditions (disequilibria) at the beginning of reform and the political feasibility of carrying forward a certain program, besides an analysis of costs and benefits (and its distribution over time) of each course of action. If the economy is in a macroeconomic crises with accelerating inflation and severe balance of payments problems, comprehensive macro restraint might be almost inescapable. Eastern Europe after 1989 and Russia 1992 are examples of that as well as the Latin American cases reviewed in the paper. On the contrary if reforms start from relatively balanced macroeconomic conditions there is much more room for gradualism as the case of China eloquently shows.

Regarding the political preconditions behind a program, shock treatment requires a strong government with broad social support since the costs of the policies are paid upfront and the benefits may take time to accrue. However, if the program brings along protracted social hardship (due to cuts in real wages, unemployment, slow recovery of growth) the initial political support may start evaporating and pressure will build up for an eventual reversal of reforms (e.g., Poland in mid-1992).

(ii) **Macroeconomic Consolidation versus Rapid Liberalization.** This issue is related to the former one though it is not the same. Here, the issue refers to the sequence between macroeconomic adjustment and consolidation and structural reforms. There are areas in which both set of policies reinforce each other; conversely, there are other areas in which stabilization and liberalization may enter in conflict. On the one hand, implementing a tax reform and the conversion of quotas to tariffs are policies that improve the fiscal budget, thus they contribute to macroeconomic stabilization. Conversely, premature financial liberalization before the budget is balanced, and real interest rates are at a reasonable level may lead to a financial crises, whose solution is fiscally costly and destabilizing, as it happened to occur in Chile in 1982-83.

Massive privatization of large scale firms can have both stabilizing or destabilizing macroeconomic effects. On the one hand it may save the government scarce resources if it implies getting rid of loss-making public enterprises, in this case public finances improve with the ensuing contribution to macro stabilization. On the other hand, if privatization involve massive liquidation of existing enterprises, the output and unemployment costs of privatization may become socially unsustainable and thus pressure will mount for the government to go in financial rescue of those enterprises. In this latter case the process of macroeconomic stabilization will be hindered.

(iii) **Price Reform and Inflation.** The shift from an economy with a vast array of controlled prices to a system in which most prices are market-determined, in general involve (an often large) hike in the price level. Recent examples of this are the outbursts of inflation observed in most economies of Eastern Europe during 1990-1991 and in Russia in early 1992, following price decontrol, currency devaluation and adjustment in prices of public utilities and energy. Moreover, the initial price shock has been followed by considerable inflationary persistence in Poland, Bulgaria and Romania. In non-socialist countries, inflationary persistence because of monetary accommodation, indexation and credibility problems, is a well known phenomena, particularly in chronic inflation economies of Latin America. This stubbornness of inflation is illustrated with the cases of Chile and Mexico, where, after sustained application of stabilization programs, the convergence to 20-25 percent annual inflation rates, starting from three digits levels, took around 7 years.

(iv) **Patterns of Output, Investment and Export Response to Adjustment.** A contraction in aggregate economic activity of considerable magnitude was observed after the implementation of shock programs, compounded by negative external shocks, in several Latin American and Eastern European economies.

Comparatively, the degree of economic contraction in the post-socialist transitions of Eastern Europe, is far deeper than in the adjusting Latin American economies reviewed here. In contrast, socialist China avoided that pattern of initial contraction as GDP growth accelerated sharply in the aftermath of gradual reform.

The recovery of capital formation and the resumption of sustainable growth is often a slow and complicated process. In Chile and Mexico it took half a decade or so, to get a sustained response of private investment in the aftermath of reform. The response of domestic private capital formation in Eastern Europe might be even longer giving the obvious supply problems and institutional weakness of the post-socialist system.

In the Latin American context, Chile (and to a less extent Mexico and Bolivia) experienced a strong expansion of non-traditional exports (though with a still modest intensity of value added) following the establishment of competitive real exchange rates and lower import duties. In Eastern Europe, an initial expansion in exports to the west also took place in Poland and other countries in response to large currency depreciation and declines in domestic absorption.

(v) **Distributive Effects and the Costs of Adjustment.** The available evidence for Chile and Mexico, suggest a worsening in income distribution in initial years of reform as a consequence of cuts in real wages and/or increases in unemployment.Those effects were meliorated for very low income groups, receiving targeted social spending. In Eastern Europe after 1989 real wages have declined substantially (30 percent or so on average) and unemployment is growing (around 11-12 percent) following the implementation of adjustment programs. The rise of unemployment in economies in which full employment was an entitlement is bringing a sense of economic insecurity and anxiety,new for people raised under socialism. In addition, the Darwinian-Schumpeterian process of economic differentiation under market systems is bound to increase (through fair and unfair mechanisms)the degree of economic inequality in these economies.

(vi) **Political Economy Considerations.** The sample of countries reviewed here can be partitioned into two groups regarding the political conditions under which economic reform is undertaken. One group is formed by countries that launched economic reform under authoritarian conditions. This is the case of Pinochet's Chile, China and Korea. In these cases, economic reforms were carried out by authoritarian governments that postponed political reform in order to gain political legitimacy from the fruits of consolidated economic reform. A second group is formed by countries where economic reform is conducted in (emergent) democracies. This is the case of Eastern Europe (and Russia) in which reforms are pursued simultaneously in the political and economic fronts. As it could be anticipated, fragile democracies with a fragmented party system and weak social institutions and governments do not provide the most favorable political environment for implementing and consolidating complex and painful economic reforms. Under these conditions, governments are bound to face the difficult dilemma of either postponing economic reform in order to avert a political crises or to backslide in the democratization process in order to apply painful economic policies. Certainly both are unsavory choices.

Table 10

Score Card on Economic Reform

(1) Initial Conditions before Reform

Macroeconomic crises	Extensive price controls trade barriers financial repression but moderate open macro imbalances
Chile	Czechoslovakia
Mexico	China
Bolivia	Bulgaria
Poland	Romania

(2) Structural Features

Income levels per capita: Low — Large economy	Low — Small economy	Medium	Share of state sector: High	Share of state sector: Intermediate
China	Bolivia	Chile	Eastern European	Chile
		Mexico	China	Mexico
		Poland		Bolivia
		Czechoslovakia		
		Hungary		
		Bulgaria		
		Romania		

Program Design

Price Reform: Shock	Price Reform: Gradual	Current Account Convertibility and Trade Liberalization: Shock	Current Account Convertibility and Trade Liberalization: Gradual	Fiscal Adjustment: Deep	Fiscal Adjustment: Moderate	Capital Account convertibility: Shock	Capital Account convertibility: Gradual
Chile	China	Bolivia	Chile	Chile	Bolivia		Chile
Bolivia	Hungary	Poland	Mexico	Mexico			Eastern Europe
Poland		Czechoslovakia	China				
Bulgaria		Bulgaria	Hungary				
Romania							
Czechoslovakia							

Policy Performance

Inflation: Initial acceleration — Sharp (more than 50% per year)	Inflation: Initial acceleration — Moderate (less than 50% per year)	Inflation: Speed of disinflation — Rapid	Inflation: Speed of disinflation — Slow	GDP Response: Initial contraction	GDP Response: Initial expansion	GDP Response: Speed of resumption of growth — Rapid	GDP Response: Speed of resumption of growth — Slow
Bulgaria	Czechoslovakia	Bolivia	Chile	Chile	China	Chile	Bolivia
Romania	Hungary	Czechoslovakia	Mexico	Mexico			Mexico
Chile	China	Hungary	Poland	Bolivia			Eastern Europe
Poland		China	Romania	All Eastern Europe			
Mexico			Bulgaria				

Political Economy

Reforms conducted by

Authoritarian regimes	Non-Authoritian regimes
Chile	Mexico
Korea	Bolivia
China	Post-1989 East-Central European regimes

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